BEFORE THE DEPARTMENT OF NATURAL RESOURCES
AND CONSERVATION OF THE STATE OF MONTANA

In the matter of the Petition of Ranck Oil Company for an administrative declaratory ruling upon the application of section 77-3-434, MCA, and ARM 36.25.210 as applied to State of Montana oil and gas leases nos. 11,526-69; 11,527-69; 13,030-71; 13,032-71; 15,453-73; 15,460-73; 15,919-74; 16,682-75; 17,533-76; 18,430-77; 19,581-78; 26,512-82; 27,293-84; 28,627-86; 28,757-86; 28,796-86; and 30,047-91 during the period from January 1, 2002 through December 31, 2006	))))))))))))))	DECLARATORY RULING

To: All Concerned Persons

1. Petitioner's name and address is: Ranck Oil Company, Inc., P.O. Box 548, Cut Bank, MT 59427.

2. The statute and administrative rule as to which petitioner requested a declaratory ruling is 77-3-434, MCA and ARM 36.25.210, as applied to state of Montana oil and gas lease numbers 11,526-69; 11,527-69; 13,030-71; 13,032-71; 15,453-73; 15460-73; 15,919-74; 16,682-75; 17,533-76; 18,430-77; 19,581-78; 26,512-82; 27,293-84; 28,627-86; 28,757-86; 28,796-86; and 30,047-91.

3. The question presented for declaratory ruling by the department is to whether lessees under Montana oil and gas leases could deduct any post-wellhead costs from the royalties to be paid to the state.

4. Declaratory Ruling

INTRODUCTION AND PROCEDURAL HISTORY

1. The Department initiated a royalty audit of eighteen State of Montana oil and gas leases held by Ranck Oil Company (Ranck) for the audit period of January 1, 2002 through December 31, 2006, under the authority granted to it by § 77-3-435(3), MCA. In response, Ranck filed a petition with the Department for an administrative declaratory ruling under § 2-4-501, MCA. Ranck requested that the Department render an opinion as to whether lessees under Montana oil and gas leases could deduct any post-wellhead costs from the royalties to be paid to the State.

2. The Department declined to issue a declaratory ruling, citing Ranck's failure to submit the gas purchase contracts by which Ranck and its affiliates sold the production to third party purchasers. The Department reasoned that absent

submission of the contracts, Ranck had failed to comply with Admin. R. M. 1.3.227(2)(b) and (c), which require that the petition for an administrative ruling contain "a detailed statement of facts upon which petitioner requests the agency to base its declaratory ruling" and "sufficient facts to show that petitioner will be affected by the ruling." The third party purchase contracts constituted—in the Department's view—the essential factual basis for a declaratory ruling.

3. Ranck sought judicial review of the Department's decision not to issue a declaratory ruling. The First Judicial District Court, Lewis and Clark County, granted Ranck's petition for judicial review. The court determined that "the question of whether Ranck is entitled to deduct development and transportation costs from the gas produced from State leases is a question that can be answered without particular reference to those actual expenses." The court rejected the Department's argument that the sales contracts were necessary for a declaratory ruling and determined that "Ranck is either entitled to deduct those costs and expenses or it is not." The court directed the Department to grant Ranck's petition for an administrative declaratory ruling.

<u>SCOPE OF ADMINISTRATIVE RULING</u>

4. The Department issues the following declaratory ruling in response to Ranck's Renewed Petition (Petition) dated August 9, 2010. The Petition requests a ruling as to the application of § 77-3-434, MCA, and Admin. R. M. 36.25.210 to sales of natural gas occurring between January 1, 2002 and December 31, 2006 under eighteen State of Montana oil and gas leases to which Ranck is a party. The Department has addressed the questions presented in the Petition based on an application of the specified statutory and administrative provisions of Montana law to the terms of these leases and to the facts described in the Petition. This Declaratory Ruling is restricted to the production and sale of natural gas and does not address sales of oil.

<u>RELEVANT PROVISIONS OF LAW</u>

5. Ranck requests an Administrative Declaratory Ruling as to how Admin. R. M. 36.25.210 and § 77-3-434, MCA, apply to the facts described in the Petition. These provisions are reproduced below.

a. <u>36.25.210 ROYALTIES</u>

(1) The lessee shall pay in cash or deliver in kind to the lessor at its option, on all oil and gas produced and saved from the leased premises and not used for light, fuel and operation purposes on the leased premises, a royalty. The royalty shall be at the following rates unless, in regard to a particular lease, the department advertises in its lease sale notices that the royalty will be at a higher rate:

(a) On gas at the rate of 16.67%;

(b) On oil at the rate of 16.67%; and

(c) The royalty on gas, including casing-head gas and all gaseous substances, while the same is not sold or used off the premises shall be at the rate of $400 per well each year or the amount of the annual rental provided in the lease, in lieu of the per well rate, whichever is the greater, payable on or before the annual anniversary date of the lease. As long as the leased lands contain a well capable of such production and such payment is made, the lease shall be considered a producing lease under the lease terms.

(2) The lessee shall pay royalties reserved to the state, in cash:

(a) on the reserved fraction of oil, the posted field price, or in lieu thereof, if no field price is posted, the fair market value in the field where produced on the day it is run into the pipeline or storage tanks; and

(b) on the reserved fraction of gas, the posted field price, or in lieu thereof, if no field price is posted, the fair market value at the well. In addition, the lessee shall pay to the state on the reserved fraction any bonus actually paid or agreed to be paid to the lessee for such oil or gas.

(3) All royalties, whether in money or in kind, shall be delivered to the state free of cost and deductions.

b. 77-3-434. Manner of making royalty payment. Such lease shall provide for the rendering of payment of such royalty on all oil and gas produced and saved and sold or used off the premises in the following manner and upon the following terms:

i. (1) the lessee shall pay to the state in cash, for all oil and gas royalty reserved, the posted field price existing on the day such oil or gas is run into any pipeline or storage tank to the credit of the lessee, plus any bonus actually paid or agreed to be paid to the lessee for such oil or gas; or

ii. (2) at the option of the state exercised in writing by the board not oftener than every 30 days, the lessee shall deliver the state's royalty oil or gas free of cost or deductions into the pipeline to which the wells of the lessee may be connected or into any storage designated by the state and connected with such wells.

<u>QUESTIONS PRESENTED</u>

6. A party may seek a declaratory ruling from an agency when "doubt exists as to how a statute or rule administered by an agency affects the party's legal rights." Admin. R. M. 1.3.226. In its Renewed Petition for Declaratory Ruling, Ranck presented the following questions to be resolved by the Department:

a. Whether the "wellhead jurisdiction" rule applies to the State leases and allows the lessee to deduct reasonable post-wellhead costs?

b. If the answer to the preceding question is that a version of the "marketable condition" rule—rather than the "wellhead jurisdiction" rule—applies to the State leases: (i) at what point does the State's royalty gas become "marketable" so as to allow post-wellhead/pre-transmission costs to be deducted; and (ii) specifically, whether actual post-wellhead gathering and compression costs are nonetheless deductible.

c. In respect to any post-wellhead costs allowed under either approach discussed above, the services for which are provided by an affiliate of the lessee: (i) whether the lessee is allowed to deduct an amount imputed from the affiliate's charges against third-parties for similar services, or whether the lessee is allowed to deduct only the affiliate's actual costs in providing the involved service, and (ii) if the latter, what element of the affiliate's actual costs are deductible?

<u>ANALYSIS AND RULING</u>
<u>QUESTION ONE</u>

7. Whether the "wellhead jurisdiction" rule applies to the State Leases and allows the lessee to deduct reasonable post-wellhead costs?

8. Summary of Ruling: Pursuant to Admin. R. M. 36.25.210(3), Ranck may not make deductions from the State's royalties for costs incurred in the production, storage, treatment, compression, marketing, or transportation of any gas production from the State leases. State royalties are payable upon the greater of: the gross proceeds obtained or obtainable by the lessee for the marketable production at the point of sale chosen by the lessee; or the fair market value of the marketable production at the wellhead. The State's royalties are not calculated upon the net profits of the lessee. Ranck is obligated to pay all royalties free of all costs and deductions.

9. Ranck erroneously requests that the Department employ a general "jurisdictional" interpretive methodology to determine Ranck's legal obligations without reference to the specific language of the very leases at issue. Without reference to lease language, it is impossible to describe the royalties due the lessor or to determine where gas is sold and royalties are calculated. To employ a blanket "jurisdictional" interpretive methodology is to circumvent the purpose for which the lease exists. The Department declines to adopt a jurisdictional approach without reference to the lease terms. For example, substantial variation exists in the wording of royalty clauses in State and private mineral leases; this variability results in differing legal obligations for lessees in the payment of oil and gas royalties to lessors.

10. An oil and gas lease represents a contract between a lessor and a lessee and must be construed according to established principles of contract interpretation. *See The Law of Oil and Gas*, 2 Summers (1959), Ch. 12, § 371, at 484, et seq.; *Edington v. Creek Oil Co.*, 213 Mont. 112, 121, 690 P.2d 970, 975 (1984); *Fey v. A. A. Oil Corp.*, 129 Mont. 300, 318-319, 285 P.2d 578, 587 (1955) ("Courts must interpret contracts as made by the parties, not make new ones for them, no matter how unreasonable the terms may appear."). The most fundamental rule governing oil and gas leases in Montana is that the terms of the lease are to be construed strictly against the lessee and in favor of the lessor. *See e.g. Schumacher v. Cole*, 131 Mont. 166, 172, 309 P.2d 311, 314 (1957).

11. The Department rejects Ranck's argument that a purely jurisdictional methodology should dictate how royalties are to be calculated without regard to the lease terms. Whether a mineral royalty is to be cost-free or cost-bearing depends on the wording of the royalty provisions in the lease. *See Wolfing v. Ralston*, 10 P.C.L.J. 11, 61 Cal. 288 (1882) (gross proceeds royalty distinguished from net proceeds royalty based on language of the royalty clauses). Royalties are calculated according to the language of the mineral lease; not solely upon any common-law definition of a royalty obligation. Where the lease terms are unclear, the Department will attempt to resolve questions by reference to the statutory provisions, administrative rules, implied covenants, and Montana caselaw. If no satisfactory resolution exists within the terms of Montana law, we will look to the caselaw of other jurisdictions.

12. Ranck's first question may be resolved by the application of Admin. R. M. 36.25.210(3), which is incorporated in every State oil & gas lease, and which mandates that: "All royalties, whether in money or in kind, shall be delivered to the

state free of cost and deductions." Likewise, § 77-3-432, MCA, provides that oil and gas royalties must be calculated based on the full market value of the oil or gas produced and saved from the leased land, and sets the minimum royalty for gas at 12 1/2%. That statute allows the State—at its option—to enter into a cost-sharing agreement for transportation expenses. Nothing in the statute requires the State to bear any portion of the costs incurred by a lessee prior to the point of sale of gas produced from a State lease.

13. Ranck requests that the Department declare the State's "royalty" to be a "net" share of produced minerals in their unmarketable condition at the site of the lease, and that the State should disregard the purchase price obtained by Ranck and its affiliates from the first arm's-length sale of the production. Ranck further requests that the Department declare that all royalties be paid at the wellhead, despite lease terms that grant the State a share of the gross proceeds from the actual sale of the production, regardless of where the sale occurs.

14. The lease terms, statutory provisions, and administrative rules dictate that State royalties are to be calculated upon actual gross proceeds obtained by the lessee of a marketable product at the point of sale of production, wherever that sale occurs—on or off the lease premises. The fair market value of the gas at the wellhead represents the minimum amount on which a royalty may be calculated. The lessee may not make self-serving determinations about the value of production or its costs of production, marketing, and transportation that bind the lessor. Such determinations constitute self-dealing and are prohibited. *See, Harding v. Cameron*, 220 F. Supp. 466 (W.D. Okla. 1963)

15. The implied covenant to market, which is present in every oil and gas lease in Montana, further imposes upon the lessee the legal obligation to: prepare the product for market; sell the production at the best available price; act as a reasonably prudent lessee to sell the production in the best mutual interests of the lessor and lessee; and refrain from any self-dealing. *Berthelote v. Loy Oil Co*., 95 Mont. 434, 28 P.2d 187 (1933)   Finally, § 77-3-432, MCA, describes certain aspects of the lessee's obligation to pay royalties under State of Montana oil & gas leases:

a. 77-3-432. Royalty. In each oil and gas lease granted by the state under this part, there must be reserved to the state as consideration for the lease *a royalty in all oil and gas produced and saved from all lands covered by the lease and not used for light, fuel, and operation purposes on the leased premises, which must be equivalent to the full market value*, as ascertained by the board at the date of the lease, of the estate or interest of the state in the lands and oil and gas deposits disposed of under the lease. *The royalty reservation must be set by the board but may not be less than 12 1/2% on gas* and not less than 12 1/2% on oil or casinghead gasoline for each producing well for the calendar month. *The state may share the expense of transporting the oil to the nearest market on a basis proportional to the state's royalty interest in the oil and at a rate per mile acceptable to the department* (emphasis added.)

16. It is clear from the language of § 77-3-432, MCA, the lease terms read in the context of the implied covenant to market, and the relevant statutory and administrative provisions, that royalties under State of Montana oil and gas leases represent a share of the gross proceeds generated from the first arm's-length sale of

the lessor's share of production. Lessees of oil and gas on State lands must monthly report the oil and gas produced and saved from the lease: "[t]he report shall show the amount of oil or gas produced and saved during the preceding month, the price obtained, the total amount of all sales, and any additional information as may be required, and it shall be signed by the lessee or some responsible person having knowledge thereof." Section 77-3-431, MCA. Because the State's royalties depend upon the accuracy of royalty reports, criminal sanctions are available for any intentionally false statements in such reports. Section 77-3-410, MCA.

17. The State's reporting form has no provision for reporting "net volumes" of gas sold from State trust lands. Where, as here, the State has reserved the right to take its royalty oil or gas in kind "free of cost or deduction," and the lessee is obligated to report gross gas volumes, it is clear that the lessee is obligated to pay royalties based upon the gross proceeds received by the lessee without any deductions. *See Exxon Mobil Corp. v. Alabama Dept. of Conservation and Natural Resources*, 986 So.2d 1093, 1109-1110 (Ala. 2007).

18. In order to calculate a royalty based on the gross proceeds obtained, there must be a sale of the production. Where there are no proceeds or sale, as when gas is exchanged, gas royalties must be calculated based upon the fair market value of the gas. *See Lightcap v. Mobil Oil Corp*., 562 P.2d 1 (Kan. 1977), cert. denied, 434 U.S. 876 (1978); *Matzen v. Cities Serv. Oil Co.*, 667 P.2d 337 (Kan. 1983); *See also Phillips Petroleum Co. v. Johnson*, 155 F.2d 185 (5th Cir. 1946), cert. denied 329 U.S. 730 (1946); *Phillips Petroleum Co. v. Record*, 146 F.2d 485 (5th Cir. 1944).

19. A "gross proceeds" royalty clause imposes upon the lessee all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale. *Hanna Oil and Gas Co. v. Taylor*, 759 S.W.2d 563, 564-565 (Ark. 1988) ("Unless something in the context of an agreement provides otherwise, "proceeds" generally means total proceeds."). Where parties to a lease intend to allow for deductions, the lease must expressly provide for such deductions, as by a reference to "net royalties." *Id.* at 565.

20. Ambiguity in the lease language pertaining to allocation of costs has been held insufficient to permit the lessee to deduct costs incurred between the wellhead and the point of sale. *Estate of Tawney v. Columbia Natural Resources, L.L.C.*, 633 S.E.2d 22, 24 (W. Va. 2006). The construction and interpretation of an agreement, including whether the contract is ambiguous, is a question of law. *Sec. Abstract & Title Co. v. Smith Livestock, Inc.*, 334 Mont. 172, ¶¶ 16-17, 146 P.3d 732, ¶¶ 16-17 (2006). Ranck interprets its lease-imposed royalty obligation in the context of a "market value" rather than a "gross proceeds" approach. This construction is incorrect. Contracts are viewed as a whole "so as to give effect to every part if reasonably practicable, each clause helping to interpret the other." Section 28-3-202, MCA. In the construction of an agreement, a party may not isolate individual clauses or words, but instead must "grasp the instrument by its four corners and in the light of the entire instrument" ascertain the parties' intent. *K&R Partnership v. City of Whitefish*, 344 Mont. 336, 343, 189 P.3d 593, 600 - 601 (2008). If a particular clause in a State oil and gas lease conflicts with the remainder of the lease, the general intent of the lease should prevail. *See* § 28-3-307, MCA (When

interpreting the meaning of a contract: "[p]articular clauses of a contract are subordinate to its general intent.").

21. No ambiguity exists in these State oil and gas leases. The royalty payment obligations imposed by the eighteen leases to which Ranck is a party are substantively identical despite slight variations in language that reflect the fact that the leases were entered into over a period of twenty-two years. These variations may be grouped into one of four vintages or formulations that reflect amendments to the lease form made over time. We address these iterations in chronological order.

22. Lease Nos. 11,526-69 through 11,923-69 require a "flat" royalty of 12.5% to be paid on the actual price received by the lessee. A copy of Lease No. 11,526-69 is attached to this Ruling as Exhibit "A". These leases were drafted pursuant to the "terms and provisions of Chapter 17, Title 81 Revised Codes of Montana, 1947, and all acts amendatory thereof and supplementary thereto," anticipating subsequent statutory enactments, amendments, and rulemaking actions.

23. Paragraph five of these leases requires payment upon the "total amount produced and saved," except for oil and gas used directly on the lease premises. Paragraph six requires that the lessee remit royalties based upon the "posted field price therefor existing on the day such oil or gas was run into any pipe line or storage tank to the credit of the lessee *plus any bonus or other increase in price actually paid or agreed to be paid to the lessee.*" (emphasis added). For State of Montana oil and gas leases, a "bonus" is legally defined as that additional amount or payment for the sale of the production representing an increase in the purchase price over any posted field price. *State ex rel. Dickgraber v. Sheridan*, 126 Mont. 447, 254 P.2d 390 (1953). Where there is no posted field price, therefore, the entire purchase price is considered to be a "bonus" upon which royalty is payable. Paragraph six further provides that if the State opts to have its gas delivered in lieu of cash, the delivery shall be effected "free of cost or deductions into the pipeline." Paragraph seven stipulates that "payments in cash for the royalties payable hereunder *shall never be less than the price actually obtained therefore*." (emphasis added). Specifically, paragraphs four through seven of this vintage of State lease provide:

a. (4) *The lessee shall also pay in money or in kind to the said lessor at its option as hereinafter provided during the full term of this lease a royalty on the gas* produced from the wells under this lease whether the said wells produce oil and gas or gas alone, *a flat royalty of twelve and one-half per centum (12 1/2%)*.

b. (5) All wells under this lease shall be so drilled, maintained and operated as to produce the maximum amount of oil and/or gas which can be secured without injury to the wells and the aforesaid royalties shall be based and calculated on such full production of oil and/or gas; but the lessee shall have the right to apply to the State Board of Land Commissioners for permission to curtail production as provided in paragraph 12 of this lease. *All royalties shall be calculated upon the total amount produced and saved under this lease exclusive of oil or gas used for light, fuel or operating purposes in connection with the work on the lands under the lease*.

c. (6) *The lessee shall pay to the lessor in cash for such royalty oil and gas at the rate of the posted field price therefor existing on the day such oil or gas was run into any pipe line or storage tank to the credit of the lessee plus any bonus or other increase in price actually paid or agreed to be paid to the lessee; provided,* *however, that at the option of the lessor exercised not oftener than once every thirty days by notice in writing the lessee shall deliver the State's royalty oil or gas free of cost or deductions into the pipe line to which the wells of the lessee may be connected or into any storage designated by the State* and connected with such wells. The lessee shall not be required to furnish storage for the State's royalty oil for more than thirty days following the date of production thereof when a market therefor is available.

d. (7) *In all cases where there is no posted field price for oil or gas produced under this lease, the payments in cash for the royalties payable hereunder shall never be less than the price actually obtained therefor* or the reasonable market value thereof at the wells produced at the time of the sale of the same; and if the price obtained appears to the State Board of Land Commissioners to be less than the actual reasonable market value, then such actual reasonable market value shall be fixed and determined by mutual agreement between the lessee and the said Board. This lease is granted upon the express condition that the value of the State's royalty gas shall not at any time be figured at less than five cents (5¢) per 1,000 cubic feet (emphasis added).

24. In *Clark v. Slick Oil Co.*, 211 P. 496 (Okla. 1922), the royalty clause in an oil and gas lease provided that the lessee was "to deliver to the credit of the lessor... free of cost, in the pipeline to which lessee…may connect the well or wells, the equal one-eighth part of all oil produced and saved from the leased premises." *Id*. at 497. Production was obtained, but the oil produced was "cut oil" contaminated with water and mud. In order to market the oil, the oil needed to be treated to remove the mud and water by being placed in settling tanks before a pipeline would accept the oil for purchase. When the treated oil sold for an amount above the posted field price, the lessor requested that royalties be paid on the higher price. The lessee refused to pay royalties above the posted field price, and it further refused to provide the Lessor with tanks to treat the lessor's royalty oil to render it marketable. The court held:

a. It was not necessary for the plaintiff [the Lessor] to treat his part of this oil and make it marketable so that the pipe line companies would receive it. Neither was he required to provide storage tanks in which to let the "cut oil" settle. It was just as much a part of the duty of the defendant [the Lessee] under the contract to prepare this oil for market so that it would be received by the pipe line company as it was its duty to pump the oil from the wells or drill the wells. The plaintiff had a right to demand his oil delivered in the pipe line, and the defendant's duty was not discharged until it was so delivered.

25. *Id.* at 501. Thus, to "deliver the State's royalty oil or gas free of cost or deductions into the pipe line to which the wells of the lessee may be connected," means that the lessee is obligated to place the production in marketable condition and pay royalties to the State upon the gross proceeds received or receivable by the Lessee at the point of sale of the production.

26. Lease Nos. 13,030-71 – 16,682-75 are substantially identical to the earlier iteration of the lease form. A copy of Lease No. 13,030-71 is attached to this Ruling as Exhibit "B". These leases contain an additional provision after paragraph 22, whereby the lessee expressly agrees to "comply with all applicable laws and regulations in effect at the date of this lease, or which may, from time, be adopted

and which do not impair the obligations of this contract and which do not deprive the lessee of an existing property right." This addition acknowledges the fact that the State Land Board and Department are empowered to make and amend administrative rules relating to oil and gas leases to ensure that the trust mandate is being fulfilled.

27. Lease Nos. 17,533-76 – 26,512-82 contain several amendments. A copy of Lease No. 17,533-76 is attached to this Ruling as Exhibit "C". Paragraph four of these leases states:

a. 4. The lessee shall also pay in money or in kind to the lessor at its option as hereinafter provided during the full term of this lease, free of costs and deductions, a royalty on the gas produced from the wells under this lease whether the wells produce oil and gas or gas alone, of twelve and one-half per centum (12 1/2%).

This iteration of the lease form also incorporates the clause pertaining to existing and new provisions of the law as paragraph 23.

28. The remaining lease forms are substantially identical. Lease Nos. 28,627-86 – 30,047-91 contain an amended oil royalty clause to establish a flat royalty (rather than a graduated royalty based on production) of 13%. The gas royalty provision is identical with earlier versions. A copy of Lease No. 28,627-86 is attached to this Ruling as Exhibit "D".

29. Each of these lease forms obligates the lessee to pay royalties upon the higher of: the gross proceeds obtained or obtainable at the point of sale; or the fair market value of the marketable gas at the wellhead. There are no deductions from the State's royalties prior to the point of sale, because each lease provides that royalties owed by the lessee are to be calculated based on the "total amount of production produced and saved," and the leases are issued in compliance with the Statutes and administrative rules in force at the time and to comport with future amendments.

30. In Montana, oil and gas leases are to be construed liberally in favor of the lessor and strictly against the lessee. *See e.g*. *Clawson v. Berklund*, 188 Mont. 48, 610 P.2d 1168 (1980); *Christian v. A.A. Oil Corp. and Byrne*, 161 Mont. 420, 506 P.2d 1369 (1973); *McDaniel v. Hagar-Stevenson Oil Co.*, 70 Mont. 156, 224 P. 870 (1924). This rule of construction is based on the recognition that the bargaining power between a lessor and lessee is unequal and that the lessor depends wholly upon the good faith of the lessee to operate the lease in the mutual best interests of the lessor and lessee. *Ladd v. Upham*, 58 S.W.2d 1037, 1039 (Tex.Civ.App. 1933). Montana law recognizes and attempts to redress this power imbalance by providing that in any contract between a public body and a private party, a court will presume that all uncertainty was caused by the private party, and will accordingly interpret the contract in favor of the public party. Section 28-3-206, MCA.

31. This presumption in favor of the public lessor is only strengthened where oil and gas leases are issued upon State school trust lands. Pursuant to Art. X, § 4 of the 1972 Montana Constitution, and § 77-1-202, MCA, the State Board of Land Commissioners is obligated to manage these lands as a fiduciary to secure the largest measure of legitimate and reasonable advantage to the State, and to provide for the long-term financial support of education. In keeping with this constitutional and statutory mandate, "[a] lease of school lands constitutes a contract between the

state and the lessee, which vitally affects the public interest, and should be construed liberally in favor of the public." *State v. Moncrief*, 720 P.2d 470, 475 (Wyo. 1986); *see also, Plateau Mining Co. v. Utah Division of State Lands and Forestry*, 802 P.2d 720 at 729 (Utah 1990) (The state has a duty not to act in the interest of a third party at the expense of school trust beneficiaries; the mineral lessees of such lands should have known that they were obligated to comply with the highest valuation of royalties under such leases).

32. Because oil and gas leases upon school trust lands in Montana are liberally construed in favor of the lessor and strictly against the lessee, the royalty clauses would have to expressly describe and authorize how those deductions were to take place in order for Ranck to take any such deductions. At a minimum, the leases themselves would need to mention "net royalties." No language is present in these leases that authorize the taking of deductions. No deductions may therefore be taken from the State's royalties under these agreements. *See West v. Alpar Res., Inc.,* 298 N.W.2d 484 (N.D. 1980) (lease that did not provide for allocation of costs was ambiguous, and must be construed against lessee and deductions by lessee were improper); *Savage v. Williams Production RMT Co.,* 140 P.3d 6, 69 (Colo. App. 2005). The variation in language displayed by the different lease forms does not undermine this basic premise.

33. Montana law provides that royalties for oil and gas leases on State lands "must be equivalent to the full market value" of the property interest represented by the lease. Section 77-3-432, MCA. The state "*may* share the expense of transporting the oil to the nearest market on a basis proportional to the state's royalty interest in the oil and at a rate per mile acceptable to the department." *Id.* (emphasis added). "The State may, also at its option, require the lessee to deliver the state's royalty oil or gas *free of cost or deductions* into the pipeline to which the wells of the lessee may be connected." Section 77-3-434(2), MCA (emphasis added). Admin. R. M. 36.25.210(3) requires that "[a]ll royalties, whether in money or in kind, shall be delivered to the state free of cost and deductions." All but four of the leases to which Ranck is a party expressly stipulate that "the lessee agrees to comply with all applicable laws and regulations in effect at the date of this lease, *or which may, from time to time, be adopted*." The other four leases (Leases 11,526-69; 11,527-69; 13,030-71; and 13,032-71) were expressly issued pursuant to the limitations in Montana's statutes "and all acts amendatory thereof and supplementary thereto."

34. Admin. R. M. 36.25.210, moreover, reflects a codification of the long-standing recognition that the State's royalty interest is to be paid free of all costs. In the context of federal mineral leases, the D.C. Circuit has determined that where a modified federal regulation pertaining to royalty calculations reflected historic department policy, it was not unreasonable and was properly applied retroactively to federal oil and gas lessees. *Independent Petroleum Ass'n of America v. DeWitt*, 279 F.3d 1036, 1041 (D.D.C. 2002).

35. Each of these provisions contemplates—either explicitly or implicitly—the State's receipt of its royalties free of costs or deductions by the lessee. The Alabama Supreme Court addressed an analogous situation in which the state had reserved the right to take its royalty oil or gas in kind "free of cost or deduction" and the lessee was obligated to report gross gas volumes. *Exxon Mobil Corp. v. Alabama Dept. of Conserv. and Nat. Res.*, 986 So.2d 1093, 1109-1110 (Ala. 2007).

The court determined that this language implicated a "gross proceeds" lease and triggered the lessee's duty to pay royalties to the state without deductions. *Id.* As discussed above, both the Montana Administrative Rules and the leases to which Ranck is a party stipulate that the State may claim its royalties "free of cost or deductions." *See* § 85-2-434(2), MCA; Amin. R. M. 36.25.210. Further, Montana lessees are required to provide a monthly report to the Department showing "the amount of oil or gas produced and saved during the preceding month, the price obtained, *the total amount of all sales*, and any additional information as may be required." Section 77-3-431, MCA. The State's oil and gas royalty reporting form effectuates this statutory mandate by requiring the lessee to report the total production and the total amount of all sales, with no provision for deductions. These production reporting requirements, viewed in light of the lease language and statutory provisions, represent a gross proceeds lease from which post-production costs are not deductible. *Exxon Mobil Corp.*, So.2d 1093, 1109-1110.

36. It is clear that Ranck may not make any deductions for the costs of preparing the production to make it marketable, or transporting the production to the point of sale from the State's royalties. Although the lease terms, statutes, and administrative rules provide clear support for the Department's ruling that a lessee's costs are not deductible from the State's royalty, this ruling is also supported by the implied covenants and rules of construction that govern the interpretation of oil and gas leases in Montana.

37. Further, the lessee's duty to market the production has been recognized in other jurisdictions to encompass the sole obligation to bear the costs associated with rendering the product marketable. Because the principle consideration for an oil and gas lease is the payment of royalties, all oil and gas leases in Montana impose upon the lessee an implied covenant to market the production. *Severson v. Barstow*, 103 Mont. 526, 63 P.2d 1022 (1936). In order to avoid lease cancellation for breach of this covenant, the burden of proof rests upon the lessee to establish that the lessee has acted with reasonable diligence. *Berthelote v. Loy Oil Co*., 95 Mont. 434, 28 P.2d 187 (1933). In judging whether a lessee has complied with the implied covenant to market, Courts will examine whether the lessee has acted as a reasonably prudent operator to market the production in the mutual best interests of both the lessor and lessee. *Fey*, 129 Mont. 300, 318, 285 P.2d 578, 587.

38. Under the implied covenant to market, moreover, a lessor has the right to be paid on the best price obtained or obtainable by the lessee. When a lessee is paying royalty based on one price but it is selling the gas for a higher price, the lessor is entitled to have its royalty payments calculated based on the higher price. *Howell v. Texaco Inc.*, 112 P.3d 1154, 1160 (Okla. 2004). Here, where Ranck obtained a higher price for itself through its affiliate, it should have remitted royalties to the Department based upon that higher price. The West Virginia Supreme Court held explicitly in *Estate of Tawney* that "at the wellhead" language in a lease was insufficient to overcome the general rule that "the lessee must bear all costs of marketing and transporting the product to the point of sale." *Id*. at 28.

39. Some courts have gone still further by adopting the view that leases containing "at the wellhead" language were completely silent as to allocation of costs. *See, Rogers v. Westerman Farm Co.*, 29 P.3d 887, 902 (Colo. 2001). Because of this silence, the court looked to the implied covenant to market to

determine the proper allocation of costs. *Id.* The implied covenant to market imposed upon the lessee the burden of any expenses incurred to render the gas marketable. *Id*. at 903. Any reasonable costs incurred to enhance the value of already marketable gas were to be shared to the extent that they actually resulted in increased royalty revenues. *Id.* The Colorado Supreme Court in *Rogers* declined to adopt a bright line rule with regard to transportation costs. The court reasoned that the distance required to transport the product to market was not relevant to a determination of how those costs should be allocated between lessor and lessee. Rather, the court held, "the determination of whether transportation costs (either short or long distance) are to be allocated between the parties is based on whether the gas is marketable before or after the transportation cost [sic] are incurred." *Id.* at 900.

40. The Supreme Court of Oklahoma similarly determined that the lessee's duty to market production from the lease includes bearing the costs of preparing the gas for market, especially where no cost sharing agreement between lessor and lessee dictates otherwise. *Wood v. TXO Production Corp.*, 854 P.2d 880, 881 (Okla. 1992). The Oklahoma Supreme Court further elaborated that the costs of compression, dehydration, and gathering under oil and gas leases on state trust lands were not chargeable to the state to the extent that these processes were necessary to render the product marketable at the point of delivery in the purchaser's pipeline. *TXO Production Corp. v. State ex rel. Com'rs of Land office*, 903 P.2d 259, 262 (Okla. 1994). The court's determination was predicated upon the lessee's implied duty to market the production and deliver the production to the point of sale. Because "gathering" costs were incurred prior to the point of sale, the Oklahoma Supreme Court held that gathering costs were not deductible from the State's gas royalties. *Id.*

41. In light of this line of precedent, Ranck's claim that "at the wellhead" language in the lease constitutes the beginning and end of the inquiry is a gross oversimplification. Neither the specific terms of the State leases nor the relevant provisions of Montana statutory and administrative law allow the deduction of expenses from the State royalty, and under the implied covenant to market, it is clear that a lessee may not deduct expenses necessary to render the gas marketable. Bearing in mind that oil and gas leases must be liberally construed in favor of the lessor and against the lessee, the Department concludes that Ranck is not entitled to take any deductions from the State's share of the gross proceeds obtained from the sale of the gas to the first arm's-length purchaser. *See West,* 298 N.W.2d 484 (N.D. 1980); *Savage v. Williams Production RMT Co.*, 140 P.3d 67, 69 (Colo. App. 2005).

42. Under the terms of the leases to which Ranck is a party, the Department concludes that neither § 77-3-434, MCA, nor Admin. R. M. 36.25.210 entitle Ranck to deduct any costs incurred prior to the gas being rendered marketable and sold. Ranck has the sole obligation to render the production marketable, and to deliver the product to the point of sale at which Ranck has chosen to sell the production.

QUESTION TWO

43. If the answer to the preceding question is that a version of the "marketable condition" rule – rather than the "wellhead jurisdiction" rule – applies to the State Leases:

a. (i) at what point does the State's royalty gas become "marketable" so as to allow post-wellhead/pre-transmission costs to be deducted; and

b. (ii) specifically, whether actual post-wellhead gathering and compression costs are nonetheless deductible.

44. Summary of Ruling: Under the terms of its leases with the State, Ranck is legally obligated to remit royalties due the State based upon the gross proceeds received or receivable by the lessee and its corporate affiliate from the first arm's-length sale of the production without any deductions for treatment, gathering, compression, transportation, or other charges. This determination is based upon the express terms of the above-captioned oil & gas leases, specific provisions of Montana statutory law and administrative rules, and fundamental principles of construction governing oil and gas agreements.

45. Ruling: State of Montana oil and gas law requires lessees to accurately report and pay royalties to the State upon the higher of:

a. 1) the purchase price received—calculated at the point of sale; or

b. 2) the purchase price receivable at the point of sale—calculated at the point of sale; or

c. 3) the fair market value of the production at the wellhead. Admin. R. M. 36.25.210; § 77-3-432, MCA.

46. Ranck fails to document how it and its corporate affiliates have determined the costs of marketing, treatment, and transportation that it seeks to deduct from the State's royalties. The creation of marketing affiliates, and the sale of production to those affiliates, allows a lessee to report lower prices for the calculation of royalties and severance taxes, which in turn allows the lessee and its corporate affiliate to capture additional profit at the expense of the lessor. The creation of marketing affiliates is often utilized by lessees seeking to unlawfully manipulate the price of production, and remit lower royalties to the lessor. Accordingly, courts have recognized that the price paid to a producer by its affiliate is not an "arms-length" sale and such sales are not a true measure of either the value of the product or the price actually received for its sale. See, *Howell*, 112 P.3d 1154 at 1158; *Beer v. XTO Energy, Inc*., 2010 WL 476715, 2 (W.D.Okla., Feb. 5, 2010).

47. The Department's determination that Ranck is required under the terms of its leases and Montana law to pay royalties based on the gross proceeds or fair market value free of costs and deductions answers in the negative Ranck's inquiry as to the deductibility of post-wellhead gathering and production costs. Ranck may not deduct any gathering or compression costs to the extent that they are incurred before the product is sold in an arm's-length transaction. As we have already stated, the lessee's duty to market the production encompasses the costs of rendering the product marketable. Marketability of production occurs at the point of the first arms-length sale to a third party purchaser. *See, Harding* , 220 F. Supp. 466 (co-owner gas purchase contracts do not create a market); *Rogers*, 29 P.3d 887, 906 ("Gas is marketable when it is in the physical condition such that it is acceptable to be bought

and sold in a commercial marketplace, and in the location of a commercial marketplace, such that it is commercially saleable in the oil and gas marketplace.").

48. Because Ranck is not entitled—under the terms of the State leases—to deduct any costs incurred prior to the point of sale, the relevant question is when the first arms-length sale occurred. Ranck transferred the State's share of production to ROC Gathering, LLP, and Commercial Energy, both of which are wholly-controlled affiliates of Ranck, and based the State's royalties upon these purported sales. Ultimately, Commercial Energy sold the production in arm's-length sales to third-party purchasers. By this mechanism, Ranck sought to improperly deduct the costs of gathering, transportation, and fuel from the payments it received for the gas from these sales.

49. The State of Montana will not recognize a sale of production between wholly-controlled corporate affiliates for the purpose of calculating the royalties due the State upon State school trust lands. *See*, *Howell*, 112 P.3d 1154 at1158 (An intra-company contract is not an arm's-length transaction, and therefore not a legal basis on which lessee may calculate royalty payments); *Harding*, 220 F. Supp. 466 (A lessee cannot act in the dual capacity of a seller and buyer of gas production and set the Lessor's royalties based upon a self-devised purchase price).

50. As the Oklahoma Supreme Court stated in *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269, 1275 (Okla. 1981):

a. Courts should take care not to allow lessors to be deprived or defrauded of their royalties by their lessees entering into illusory or collusive assignments or gas purchase contracts. Whenever a lessee or assignee is paying royalty on one price, but on resale a related entity is obtaining a higher price, the lessors are entitled to their royalty share of the higher price. *The key is common control of the two entities* (emphasis added).

51. The situation described by the court in *Tara Patrolium* equates precisely to the relationship of Ranck and its affiliate companies. The sale between Ranck and its wholly controlled affiliates does not provide a legal basis upon which lessees may calculate royalty payments and, therefore, must therefore be disregarded. Ranck may not use its affiliates to unfairly deprive the State of its royalties. *Id.* An oil company may not—where the terms of the lease dictate that royalties are never to be less than the price actually realized through the sale or fair market value—use another method of calculation that results in a royalty lower than one based on an arms-length transaction. *Shell Oil Co. v. Ross*, --- S.W.3d ----, 2010 WL 670549 (Tex. App. 2010). The first arms-length transaction occurred off the lease premises, and post-production costs up to that point of sale are not deductible by Ranck. *See Tyson v. Surf Oil Co.*, 196 So. 336 (La. 1940).

52. Because the costs that Ranck seeks to deduct were incurred prior to the first arms-length transaction, they represent costs necessary to render the gas marketable. As such, they are not deductible from the State's royalty. By deducting such costs, Ranck violated the lessee's implied covenant to market the production for the mutual benefit of lessor and lessee and failed to comply with the mandate of Admin. R. M. 36.25.210.

<u>QUESTION THREE</u>

53. In respect to any post-wellhead costs allowed under either approach discussed above, the services for which are provided by an affiliate of the lessee:

a. (i) whether the lessee is allowed to deduct an amount imputed from the affiliate's charges against third-parties for similar services, or whether the lessee is allowed to deduct only the affiliate's actual costs in providing the involved service, and

b. (ii) if the latter, what element of the affiliate's actual costs are deductible?

54. Summary of Ruling: Under the terms of the leases to which Ranck is a party, its royalty obligation must be calculated on the gross proceeds obtained or obtainable from the first arm's-length sale of the production. The lessee has an obligation imposed by the implied covenant to market to sell the gas produced at the best price available, and must operate the lease and market the production as if it were the lessee's only lease. No costs are deductible from the State's royalties calculated at the point of the first arm's-length sale, regardless of whether those costs were incurred by the lessee or a corporate affiliate of the lessee.

55. Ruling: Under the facts presented in the Petition, and as discussed above, the initial sale of gas from the lessee is a non-arm's length transfer of the gas production between two corporate affiliates. The Department will not recognize a transfer of production between corporate affiliates as a valid sale for the purposes of calculating oil and gas royalties due to State trust beneficiaries. *See Howell*, 112 P.3d 1154 at 1158.

56. In cases involving inter-affiliate transfers, royalties are calculated from the first arm's length sale of gas to a third-party purchaser. A lessee may not avoid its obligation to pay royalties to the state school trust by transferring production to an affiliate at a lower ostensible purchase price, who then sells the production to a third-party purchaser at a higher price. This constitutes self-dealing. The Department need not prove that the sale occurred as a scheme or subterfuge in order to disregard inter-affiliate sales for the purpose of calculating royalties. *Beer v. XTO Energy, Inc*., 2010 WL 476715, 2 (W.D. Okla. Feb. 5, 2010).

57. The implied covenant to reasonably market oil and gas serves to protect a lessor from the lessee's self-dealing or negligence. A lessee who receives seven-eighths of the proceeds from the sale of gas has a proper incentive to get the "best" price. A lessee who crafts sales transactions with a corporate affiliate to pass revenue to that affiliate has no incentive to obtain the best price. On the contrary, the lessee has every incentive to sell the production to its affiliate at below market value in order to reduce its royalty obligation. All revenue generated under an oil and gas lease must be shared strictly in accordance with the fractional division contemplated in the lease. The lessee may not engage in self-dealing or sales contract manipulation in order to secure more favorable terms to itself. *See Amoco Production Co. v. First Baptist Church of Pyote*, 611 S.W.2d 610, 610 (Tex. 1980) (breach of the implied covenant to market in good faith occurred where lessee sold the lessors' gas at rate substantially lower than market value, where by doing so the lessee was able to obtain for itself the collateral benefit of an increased price for gas from its other previously dedicated leases from third parties); *Amoco Production Co. v. First Baptist Church,* 579 S.W.2d 280 (Tex. Civ. App. 1979) (lessee must obtain best purchase for mutual benefit of lessor and lessee); *Klein v. Jones*, 980 F.2d 521,

532 (C.A.8 (Ark.) 1992) (oil and gas leases should be construed in manner so that lessee and the lessor split all economic benefits arising from the land).

58. Section 77-3-431, MCA, requires the royalty report to include the amount of "oil or gas produced and saved . . . and the price obtained." This statute does not mention any right of the lessee to take, or report, deductions from the gross proceeds royalty due the State. Because the State of Montana lease terms do not allow for any deductions from the lessor's royalties, the lessee has the sole obligation to place all production in marketable condition prior to the point of sale of that production. When transferring possession of the production to a commonly-controlled corporate affiliate, a lessee seeks to utilize such transactional schemes to:

a. 1) concoct a lower purchase price;

b. 2) render meaningless the implied covenant to market, and

c. 3) allow its corporate affiliate to charge against the royalty interest costs that normally would not be chargeable against the State's royalty interest under the terms of the lease contract, because those costs were incurred prior to the point of sale to a third-party purchaser. Under the facts Ranck has presented, the purchase prices and costs asserted by the corporate affiliates cannot be verified as arm's-length contracts with third-party purchasers in an open market. Therefore, the Department must ignore the inter-affiliate sales and to calculate its royalties based upon the first verifiable arms-length sale to a third-party purchaser. Schemes to manipulate the purchase price of production from State trust lands represent a violation of the implied covenant to market. By accepting royalties calculated under such methods, the Department would be remiss in its duty to enforce the express terms of these lease contracts. *Montanans for Responsible Use of School Trust v. State ex rel. Bd. of Land Comm'rs*, 296 Mont. 402, 407, 989 P.2d 800, 803 (1999); Art. X, §§ 1, 11 Mont. Const.

59. The department concludes that Ranck may not deduct costs incurred by either itself or its affiliates—ROC gathering and Commercial Energy—prior to the point of the first arms-length sale to a third party purchaser. No post-wellhead costs are deductible under the facts presented by Ranck in its Petition.

Effect of 2011 Legislation

60. Issuance of this Declaratory Ruling was delayed by consideration for possible legislative changes to the calculation of State oil and gas royalties. SB 415 by the 2011 Montana Legislature sought to revise the standard terms of State of Montana oil and gas leases so as to require royalties to be calculated at the wellhead regardless of where a State lessee sold the production, and to allow the State lessee to make certain deductions from the State's royalties.

61. SB 415 was vetoed by the Governor. A copy of the Governor's veto letter for SB 415 is attached hereto as Exhibit "E", and is incorporated herein by reference. Consequently, no enactments from the 2011 Legislature affect this Declaratory Ruling.

NOTICE

62. If all administrative remedies have been exhausted, this Administrative Declaratory Ruling may be appealed by a party in accordance with the Montana Administrative Procedure Act, Sections 2-4-501 and 2-4-701, et seq., MCA, by filing

a petition in the appropriate District Court within 30 days after service of this Final Decision upon you.

DATED this 4th day of August, 2011.

/s/ Mary Sexton____
Mary Sexton, Director
Montana DNRC

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the fore-going ADMINISTRATIVE DECLARATORY RULING AND NOTICE OF OPPORTUNITY TO SEEK JUDICIAL REVIEW was served by mail, postage prepaid, upon the following on the 4th day of August, 2011:

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